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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1942.

No. 465

IN THE MATTER OF
CHICAGO RAPID TRANSIT COMPANY,
A CORPORATION,
DEBTOR.

CHICAGO JUNCTION RAILROAD COMPANY,
A CORPORATION,
Petitioner,

vs.

A. A. SPRAGUE, BERNARD J. FALLON, TRUSTEES OF THE ESTATE OF THE CHICAGO RAPID TRANSIT COMPANY, A CORPORATION,
Respondents.

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

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RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

THE MATTER INVOLVED.

A "short statement of the matter involved" should be somewhat longer than that contained in the petition if it is to summarize accurately the holding of the Circuit Court of Appeals, viz.: that the bankruptcy court has power to authorize and direct its trustees, appointed under Section 77B of the Bankruptcy Act for an intrastate elevated

railroad, to reject the burdensome lease of a branch line and to require the trustees to continue service thereafter over the branch line, not for the account of the estate but only for the benefit and account of the lessor, and then only until the trustees shall be duly authorized by the state regulatory body to cease operation by reason either of the lessor taking over operation or the physical abandonment of such operation, the trustees to surrender possession upon either of such events, and the lessor to recover after the date of the institution of the reorganization proceedings not the contractual rental but only such amount, if any, as may be found due on an accounting by the trustees on the basis of having operated the property for the account of the lessor.

ADDITIONAL STATEMENT OF THE CASE.

We deem an additional statement also necessary to correct inaccuracies or omissions in petitioner's statement of "Facts from the Record" which stands as its statement of the case. (Petitioner's Supporting Brief, p. 10.)

Contrary to the repeated assumption in the petition (pp. 3, 5, 6, 7) that the decision below involves a period of time extending back to September, 1934, this case actually involves only the period since January 22, 1937, on which date the debtor filed its petition for reorganization under Section 77B. In the prior equity receivership case a special master's report was filed recommending that prereceivership rentals be allowed as a general claim and that unpaid rentals during part of the receivership be allowed as administration expenses (R. 53). No question of rejection of the lease was involved and the evidence relating to the allocation of expenses and revenues between the leased line and the rest of the system was not nearly so complete as that later offered in the reorganization case. Objections were filed to this report by the receivers (R. 37) and the report and objections were later transferred to the reorganization case (R. 40). There the entire matter was again referred to the special master to be reconsidered by him in connection with the evidence taken under the trustee's petition filed May 13, 1937 (R. 40). This portion of the reference relating to the situation during the receivership case is still pending before the master and is in no way involved in this case (R. 306-7).

Petitioner's statement of the case also seeks to give the impression of great delay between the institution of reorganization proceedings for the debtor and the trustees' actual election to disaffirm the lease made under the court's

order. The facts are as follows: The debtor's petition for reorganization was filed January 22, 1937 (R. 2); temporary trustees were appointed January 27, 1937 (R. 11); by an order entered on that date, amended March 2, 1937, the trustees were allowed until September 1, 1937 (unless the time were further extended), to adopt or reject leases whether made by the debtor, or the receivers, or whether affirmed or adopted by the receivers, the election to be made by written election filed in the clerk's office, and no conduct, user or payments by the trustees in the meantime were to conclude the trustees or constitute an election to adopt (R. 230-1). Extensions of time were duly ordered by the District Court until after the election to disaffirm filed by the trustees July 31, 1942 (R. 232, 271), and, in fact, as to other leases, until the present time. A permanent trustee* for the debtor was appointed March 2, 1937 (R. 271), and on May 13, 1937, he filed his original petition against The Chicago Junction Railroad Company as respondent, alleging that the number of persons riding on the Junction branches had steadily decreased within recent years, that expenses of operation had increased, that the branches were being operated at a loss principally due to the large amount of rental required to be paid, that such rental was unconscionable, excessive, and oppressive to the estate, and that if the rental under the lease was not reduced to a reasonable amount it would be necessary for the trustee to reject the lease. The trustee asked that an order be entered requiring the Junction to modify the lease by reducing the rental, and for general relief (R. 23-5).

On September 27, 1938, as partially stated in the Junction's petition for certiorari (p. 4), the trustee filed an amendment to his original petition. This stated figures showing the heavy operating losses on the Junction

* A. A. Sprague was sole permanent trustee from March 2, 1937 to March 31, 1941, when Bernard J. Fallon was appointed co-trustee. (R. 271.)

branches, and added to the existing prayers for reduction in rental and general relief, an alternative request that the trustee be allowed "to abandon the operation of said branches subject to the approval of the Illinois Commerce Commission * * * and thereupon to disaffirm and abandon said lease" (R. 30-1).

At no time did the Junction press for hearing of the matter. On the contrary, its counsel stated before the special master that he was content to wait until the general questions of the reorganization had been determined (R. 114).

Throughout the hearings before the special master the trustees urged that the lease could be and should be disaffirmed without prior approval of the Illinois Commerce Commission and on September 4, 1940, after the close of the hearings, moved to amend the prayer for relief accordingly (R. 338). Following the special master's recommendation made in his supplemental report filed October 11, 1940 (R. 325-6), such amendment was allowed to be made by the order of July 12, 1941 (R. 338-9).

SUMMARY OF ARGUMENT.

I. There has been a timely and effective rejection of the lease.

II. The bankruptcy court did not exceed its jurisdiction in applying the "net earnings" rule.

III. No franchise is being disregarded by the trustees.

IV. The judgment does not violate the statute law of Illinois.

V. The judgment is authorized by Sections 77A and 77B of the Bankruptcy Act.

VI. No contract "in the public authority" is involved.

ARGUMENT.

Since the lease is now conceded to be burdensome to the trust estate (Petition for Certiorari, p. 7), it is the trustees' position that on ordinary principles of bankruptcy law the lease has been properly disaffirmed, the reasons urged by petitioner against such disaffirmance having no substantial validity. But before taking up petitioner's several points for specific answer we would point out what its contentions really amount to—that the lessor-petitioner and in turn the holders and guarantors of its first mortgage bonds (the only persons really interested in the petitioner (R. 103-4, 236)) are entitled to preferential treatment in the reorganization of Chicago Rapid Transit Company at the expense of the holders of first mortgage bonds covering various sections of Rapid Transit's owned lines. The petitioner's bondholders have between themselves and the trust estate of Rapid Transit an indenture of lease as well as an indenture of mortgage, and their real contention is that because of the lease they are entitled to receive their stipulated rental, and in turn the mortgage bond interest, despite the extremely burdensome character of the lease.

I.

There Has Been a Timely and Effective Rejection of the Lease.

We are only concerned in this case with what has happened in the reorganization proceedings with respect to the lease in question. Payment of rent by the prior equity receivers or action or nonaction by them with respect to the lease can have no effect upon the power of the bankruptcy court to order its trustees to reject the burdensome

lease. Section 77B(c)(5) of the Bankruptcy Act (U. S. C. A., Title 11, section 207(c)(5)); *In re 211 East Delaware Place,* 76 F. (2d) 834, 836 (C. C. A. 7, 1935); cf. *Gross* v. *Irving Trust Co.,* 289 U. S. 342 (1933).

So far as the reorganization proceedings are concerned, the permanent trustee acted within two months and eleven days of his appointment (R. 21, 271). His original petition alleged that the lease was unprofitable and burdensome, asked that the rent be reduced, stated that if the rent were not reduced the lease would be rejected, and prayed for general relief (R. 25). This was a realistic approach to the problem based upon the experience of railroad reorganizers where the practical consequence of a rejection has frequently been a new lease at a lower rental. 6 University of Chicago Law Review, pp. 698-700 (1939).

Later the prayer of the petition was twice amended, but as the master's report on the last amendment (R. 325-6) makes clear (and without objection from petitioner) there was never any deviation at the trial of the case from the theory spelled out in the last amendment to the prayer—that the lease should be disaffirmed without first presenting the matter to the Illinois Commerce Commission (R. 324)—which theory was always within the scope of the prayer for general relief.

Not only did the trustees' original petition make it plain that the lease would be rejected unless the rent was reduced, but in its answer filed June 8, 1937 the Junction, in effect, recognized these alternatives and urged the adoption of the lease and the payment of the rent (R. 26-8). From then on the Junction showed no disposition to press the matter. Its counsel stated before the special master:

> "That, so long as the whole traction question was in the hands of the court, and this necessarily would have to be delayed when that comes to a head, that it would hardly do anything, perhaps, but impose ourselves, to go in and try to throw Judge Wilkerson's

> course off to one side long enough to determine the question of this lease." (R. 114.)

The trustee never varied from his original position that the lease was burdensome and the rental unconscionably high. No rent was ever paid during the reorganization proceedings.

While time passed the Junction had its remedies, but it did not seek them, and it may not now claim that the equities are tipped in its favor by lapse of time. This Court stated in *Philadelphia Co.* v. *Dipple*, 312 U. S. 168, 174 (1941):

> "If, in the opinion of the officers of the underlying companies [the lessors], a reasonable time has expired those companies are not without redress. They may declare a forfeiture of the leases and abrogate the agreements for nonperformance on the part of the trustees or, they may apply to the District Court to compel an election by the trustees, to affirm or disaffirm."

In *Texas Co.* v. *Chicago & A. R. Co.*, 126 F. (2d) 83 (C. C. A. 7, 1942), an equity receivership case, the right of disaffirmance was held to persist under orders extending the time, not only during nine years of receivership but, as respects a purchaser of the property at judicial sale, for nine years after such sale.

Petitioner also mentions the reference in the dissenting opinion to the supposed inconsistency of directing a lessee after disaffirmance to remain in possession of the property and charge the deficit to the lessor. We believe that a brief analysis of the rights and duties of the parties should disprove the existence of any inconsistency.

The lessor and lessee are governed not only by the lease but by the character of the property leased. The contract of lease says that for the use of the property certain money shall be paid; the Illinois statute says that until the Commission acts, railroad operations must continue. This last, so far as the relative rights of the lessor and

the lessee are concerned, means no more than that until the Commission acts the lessor cannot get back its property, which by the lease was devoted to the public use many years ago, unless it re-enters and operates the property. But that fact should not make its contract rights any less subject to readjustment under the bankruptcy laws than those of the bondholders of the Rapid Transit Company who devoted their property to the use of the lessee corporation and who now likewise cannot realize in full upon either their money or upon the property mortgaged to secure its repayment.

The bankruptcy law covers the reorganization of public utilities and specifically provides that leases may be rejected. If a lease may not be rejected unless a state commission first permits physical abandonment of operations by the lessee, then there has been added to the law something which the Congress did not enact and which in effect nullifies the right to reject and disaffirm.

Even though possession of the property has to be retained physically after disaffirmance by virtue of the lessor's refusal or inability to continue operation of its public utility property, if the trust estate relinquishes all claim to the lease and rejects all benefit under the lease then the lease as a contractual obligation is at an end. It is then "no case of the employment of the property of another for one's own benefit." *Quincy, etc. R. Co.* v. *Humphreys,* 145 U. S. 82, 101 (1892); *Green* v. *Finnigan Realty Co.,* 70 F. (2d) 465, 466 (C. C. A. 5, 1934); *In re Connecticut Co.,* 95 F. (2d) 311, 316 (C. C. A. 2, 1938).

The foregoing principles have been enacted as a part of the railroad reorganization section of the Bankruptcy Act where it is provided (Section 77(c)(6), U. S. C. A., Title 11, sec. 205(c)(6)):

> "(6) If a lease of a line of railroad is rejected, and if the lessee, with the approval of the judge, shall elect no longer to operate the leased line, it shall be the duty

> of the lessor at the end of a period to be fixed by the judge to begin the operation of such line, unless the judge, upon the petition of the lessor, shall decree after hearing that it would be impracticable and contrary to the public interest for the lessor to operate the said line, in which event it shall be the duty of the lessee to continue operation on or for the account of the lessor until the abandonment of such line is authorized by the Commission in accordance with the provisions of section 1 of Title 49."

This language to which we refer merely by way of analogy has been considered to be no more than a codification of pre-existing equity receivership principles. *In re N. Y. N. H. & H. R. Co.,* 26 F. Supp. 18 (D. C., Conn., 1939) (affirmed *sub nomine Palmer* v. *Warren,* 108 F. (2d) 164 (C. C. A. 2, 1940) and affirmed *sub nomine Warren* v. *Palmer,* 310 U. S. 132).

There is, however, a closer analogy from the railroad cases, for there this Court has recognized that there may be the rejection of a lease without abandonment of service, *Warren* v. *Palmer,* 310 U. S. 132 (1940), even though permission to abandon local service may be obtained only from the State Commission. *Palmer* v. *Massachusetts,* 308 U. S. 79 (1939).

II.

The Bankruptcy Court Did Not Exceed Its Jurisdiction in Applying the "Net Earnings" Rule.

Petitioner asserts that the bankruptcy court lacked jurisdiction to impose affirmative liability upon petitioner for deficits caused by the trustees' operation over its structure, but supports such assertion merely by the citation of three cases.

Only the first of these, *Gaston* v. *Rutland R. Co.,* 35 F. (2d) 685 (C. C. A. 2, 1929), dealt with a railroad lease and there the leased property, a bridge, did not constitute in

any sense a separate division, but was located upon a branch line of the Central Vermont over which operations were conducted on each side of the bridge property. Since the receivers intended to operate the branch at either end of the bridge for the benefit of their estate, and could not operate it without crossing and using the bridge, there could not be a rejection of the benefit of the bridge contract. The "net earnings rule" is not applicable to bridges. *North Kansas Bridge Co.* v. *Leness,* 82 F. (2d) 9 (C. C. A. 8, 1936). In the later case of *In re Connecticut Co.,* 95 F. (2d) 311, 316 (C. C. A. 2, 1938), the same court that decided the *Gaston* case held that an equity receiver of public utility property might reject a lease although operations might have to be carried on for some time, at the lessor's account.

The other two cases cited, *Trustees of Dartmouth College* v. *Woodward,* 4 Wheat. 518, and *Farrington* v. *Tennessee,* 95 U. S. 679, held that subsequent state legislation may not impair the obligation of prior contracts. It is, however, inherent in the very nature of bankruptcy administration that contract rights must be scaled down, altered or completely abrogated. *Continental Bank* v. *Chicago, R. I. & P. Ry. Co.,* 294 U. S. 648 (1935); *Van Huffel* v. *Harkelrode,* 284 U. S. 225 (1931).

On principle and authority the portion of the order appealed from regarding the accounting properly related back to the beginning of the reorganization proceedings. Under well settled principles of railroad receivership law, upon rejection of a lease the receivership estate is not required to pay the stipulated rental from and after the date of receivership but is required only to account to the lessor for the profit or loss from operations,—the so-called "net earnings rule." *Quincy, etc., Ry. Co.* v. *Humphreys,* 145 U. S. 82 (1892); *Westinghouse Electric & Mfg. Co.* v. *Brooklyn Rapid Transit Co.,* 6 F. (2d) 547 (C. C. A. 2, 1925); *American Brake Shoe & Foundry Co.* v. *N. Y. Rys. Co.,* 282 Fed. 523, 529 (C. C. A. 2, 1922); 46 Harvard Law Review at page 1134 (1933). The rule is recognized in

the railroad section of the Bankruptcy Act, Section 77 (c) (6), 11 U. S. C. A. section 205 (c) (6), quoted above (p. 10).

Petitioner is a railroad corporation (R. 240) and is a public utility within the definition of Section 10 of the Illinois Public Utility Act, including "every corporation * * * that now or hereafter: (a) may own within the State, directly or indirectly, for public use, any plant, equipment or property * * * used in connection with the transportation of persons or property * * *." (Illinois Revised Statutes 1941, Chap. 111⅔, sec. 10.)

In the equity receivership cases where lessors are very seldom in a position to resume the operation of branch lines, the decisions have quite uniformly required the receivers of the lessee, who may have to operate the road for some time, merely to account to the lessor for the profit or loss from operations. *Quincy, etc., R. Co.* v. *Humphreys,* 145 U. S. 82, 101 (1892); *United States Trust Co.* v. *Wabash Ry. Co.,* 150 U. S. 287, 301 (1893); *American Brake Shoe & Foundry Co.* v. *N. Y. Rys. Co.,* 282 Fed. 523, 528 (C. C. A. 2, 1922). If there are no net earnings, the lessor is chargeable with any resulting loss. *Penna. Steel Co.* v. *N. Y. City Ry. Co.,* 198 Fed. 721 (C. C. A. 2, 1912); *In re Connecticut Co.,* 95 F. (2d) 311 (C. C. A. 2, 1938).

III.

No Franchise Is Being Disregarded by the Trustees.

Petitioner urges that the provisions of the ordinance of the City of Chicago passed March 16, 1903 prevent the disaffirmance of the lease apparently because of a supposed condition enforceable by the City. The actual language of the ordinance is:

> "The rights and privileges by this section vested in said Chicago Junction Railroad Company are granted upon the express condition and agreement that said elevated railroad hereby authorized to be constructed by said Chicago Junction Railroad Company shall from its completion be permanently operated by said South Side Elevated Railroad Company, under lease or other

arrangement between the said two companies as a part or parcel of the road of said South Side Elevated Railroad Company." (R. 413.)

There are several answers to petitioner's contention, aside from the fact that the case cited by it, *Broad River Power Company* v. *South Carolina*, 281 U. S. 537 (1930) involved no question of insolvency, confiscation, or the disaffirmance of any lease.

In the first place, there could not as a matter of law be any valid requirement of such "permanent" operation, since all the other South Side Elevated franchise ordinances were of limited duration. The ordinances covering the main line of the South Side Elevated Railroad Company (the debtor's predecessor) which were granted in 1888, 1891, and 1892, and the other parts of the 1903 ordinance relating to the Englewood and Normal Park branches and a third track on the main line all expired by their terms on March 26, 1938 (R. 416). Since the main line ordinances ran for a limited period of time, the Junction cannot claim the right to operate "permanently" as a part of the system beyond the expiration date of such ordinances. *Blair* v. *City of Chicago*, 201 U. S. 400, 485-6 (1906).

The language of the ordinance itself negatives any intention that the lease between the parties could be the only possible status; rather it expressly suggested possibility of "other arrangement." Then, too, the parties to the lease did not so regard the City's act. Their lease provided that the lessor, on default, might terminate it and enter upon and possess the leased property (R. 254-5). Obviously, the lessor could not legally have done so if the ordinance restricted use solely to the debtor.

Finally the City, the direct beneficiary of whatever condition there is in the 1903 ordinance has expressly recognized the power of the bankruptcy court to direct a disaffirmance of the lease. The new ordinance passed by the

City Council June 19, 1941 recognizes that the lease in question is

> "subject to any orders which may be entered in the proceedings for reorganization * * * now pending in the District Court of the United States * * *, or by the Illinois Commerce Commission." (R. 378.)

and that the obligation of the New Company to assume leases, including the Junction lease, is only

> "to the extent and in the manner provided by order or decree of the Federal Court having custody of the properties of the Debtor." (R. 376.)

IV.

The Judgment Does Not Violate the Statute Law of Illinois.

In support of its point that the judgment violates the statute law of Illinois, petitioner quotes Section 49a of the Illinois Public Utility Act, providing that "no public utility shall abandon or discontinue any service without first having secured the approval of the Commission." The point is answered completely in the opinion below in language which we cannot improve upon. We quote:

> "The order directed the trustees to reject the lease. Its plain purport was that thereafter the trustees should continue operation of the leased premises, not as lessees but wholly free from the obligations of the lease, temporarily, until either respondent should take back its property, as it had a right to do, or the state should grant leave to abandon the operation. To our mind this reflected a nice distinction upon the part of the court between what it might properly do and what it might not. It could reject the lease and free the estate of the burden thereof. It could not order abandonment of service. It could not make a new contract between the parties. The court rightfully protected the estate by cancellation and equally properly protected the rights of lessor by providing that until and

unless it should take over its property, the same should be operated for its account, a practice approved by the court in *Palmer* v. *Webster,* 312 U. S. 156. And it equally adequately protected continued operation as required by the utility laws of Illinois until the proper authorities should see fit to relieve both lessor and lessee of necessity of further operation. This was not creation of a new contract or modification of an old one. It was cancellation of contractual liability with preservation of the public operation as required by the laws of Illinois until the lessor could take over, or until relief of both parties from such obligation by the Illinois Commission." (R. 430.)

Recent decisions of the Supreme Court of Illinois support this analysis, holding that the Illinois Commission has no power to modify burdensome contracts between utilities, *Commerce Commission* v. *E. St. Louis & C. Ry. Co.,* 361 Ill. 606, 611-3 (1935), and that the Commission generally has no powers except those expressly granted to it by statute. *Lambdin* v. *E. St. Louis & C. Ry. Co.,* 352 Ill. 104 (1933). The case of *City of Geneseo* v. *Illinois Northern Utilities Company,* 378 Ill. 506, 527 (1941), cited by petitioner, merely holding that a public utility whose franchise has expired may not continue operations in a city which has established an adequate municipally owned utility against the wishes of such city, does not support petitioner's position; on the contrary, it strengthens the analysis above quoted, for the case also holds (p. 527) that said Section 49a affects only the operation of the utility.

V.

The Judgment Is Authorized by Sections 77A and 77B of the Bankruptcy Act.

In the argument of petitioner's supporting brief (pp. 16-17), the point is made that the judgments are not authorized by the provisions of Sections 77A and 77B of the Bankruptcy Act because the lease is a contract "in the public authority." Although the point is not raised under "Questions Presented" in the petition proper as the rules require (Rule 38), we shall answer it here and under the next heading.

Petitioner quotes the language of Section 77B (b)(6) and (e)(2) (U. S. C. A. Title 11, Section 207 (b)(6), (e)(2)) relating to plans of reorganization. These clauses have no applicability for the reason that the disaffirmance in question was ordered by the bankruptcy court under the provisions of clause (c)(5), reading "* * * the judge * * * may direct the rejection of contracts of the debtor executory in whole or in part," which covers leases as well as contracts. *Philadelphia Co.* v. *Dipple*, 312 U. S. 168, 174 (1941). No exception is made in this clause of contracts in the public authority, but even if such an exception were contained in the clause just quoted, there would still be lacking a contract in the public authority.

VI.

No Contract "in the Public Authority" Is Involved.

Petitioner now refers to Section 116 of Chapter X of the Chandler Act (U. S. C. A. Title 11, Section 516), excepting "contracts in the public authority" from the power of disaffirmance, but the reorganization proceedings of Chicago Rapid Transit Company were instituted under Section 77B long before the enactment of the Chandler

Act. Furthermore, the ordinance of 1903 referred to by petitioner could not very well require "permanent operation" by the lessee beyond the term of its main line and other franchise ordinances, and even if it could, the City of Chicago instead of insisting upon continued operation has adopted an ordinance which releases any right upon its part to insist upon such construction of the earlier ordinance (See pp. 14, 15, *ante*).

However, even if the Chandler Act should be considered applicable, we believe it should be apparent that petitioner is contending for entirely too broad an application of the phrase "in the public authority." There is here involved a lease between two public utility corporations. In a case where the contract is a lease of municipally owned property under a contract to operate, the question of physical abandonment and rejection of the benefit and change in the financial arrangement between the parties necessarily go hand in hand. But where, as in this case, the lease of privately owned property is not a contract directly with a municipality, but is a lease from another public utility, there is not the same reason for prohibiting the bankruptcy court from revising the rights of the parties.

If petitioner is right in its construction, then there is no authority anywhere which could prevent a lessor of utility property from securing, as petitioner seeks to secure here, a preferential treatment at the expense of other creditors. As pointed out above (*ante*, p. 16) the Illinois Public Utilities Law contains no provision for relief from burdensome contracts and leases, and even if the Commission could give such relief its efforts would be thwarted by Section 116 of the Chandler Act as petitioner construes it. The exception is absolute in its terms. If a particular contract is "in the public authority," there is no provision either in Section 116 relating to the powers of the court prior to the approval of any plan, or in Section 216 providing what a plan of reorganization may contain, by

which there may be any rejection of such a contract either by the court under the first section, or by the provisions of the plan under the second section.

The construction which the Junction contends for obviously is not necessary in order to protect public authorities in the cases where they really need protection, but would furnish lessors such as petitioner with a shield against the powers of the bankruptcy court to which they are not logically entitled, and which the drafters of Chapter X certainly never intended.

Conclusion.

It is respectfully submitted that the petition for a writ of certiorari in this matter should be denied.

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